

THE GOVERNANCE AND MANDATES OF THE INTERNATIONAL FINANCIAL INSTITUTIONS

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1 INTRODUCTION

The IMF and the World Bank emerged 50 years ago as a result of the deliberations at Bretton Woods. Those who attended that conference – thinkers, civil servants and political leaders – showed unusual imagination and boldness in designing a new monetary system intended to prevent a recurrence of the devastating economic and subsequently political developments that followed the first world war.¹ Bretton Woods was in a sense the antithesis of Versailles; the punitive treatment of the losers at Versailles was matched, but in mirror image, by the generosity of spirit of Bretton Woods together with the Marshall and Dodge Plans.¹ The intentions of those at Bretton Woods were realised: the post-war system did not see a return to the economic recession and mass unemployment of the 1930s; international restrictions were greatly reduced and trade and output expanded at an unprecedented rate.

Today, however, the Bretton Woods institutions are badly in need of reform, for three rather different reasons: first, in some important respects the international financial institutions (IFIs) have moved away from the intentions of the founders; second, the world today is radically different from what it was in 1945, so that the institutions designed for that era do not meet the needs of the 21st century; third, the governance structures of the institutions, never really satisfactory, seem particularly ill-suited to both today's political realities and democratic aspirations. In this article, I argue that without substantial reform, the IFIs risk becoming at best irrelevant and at worst dysfunctional.

2 THE WORLD IN 1945 AND BRETTON WOODS

The world economy of 1945 was a war economy: one of almost completely controlled trade; non-convertible currencies; a Europe devastated by war, which lacked hard currency to buy goods from the one economy which had spare capacity (the US). The memory of recession and unemployment of the 1930s was still vivid as was the process by which the economic problems following the first world war had led to horrendous political consequences. At the same time, the *laissez-faire* and monetarist economic philosophy prevalent between the wars had been displaced in official thinking by the much more interventionist views of Keynes. Those who participated at Bretton Woods not only had a very strong motive to avoid the post First World War events, but they also had a new system of thought and well-worked out mechanisms to help them do so.²

Two fundamental objectives of the Bretton Woods system emerge clearly from the Articles of Agreement of the IMF: to promote high levels of employment and real income, and to enhance world trade, by reducing restrictions on trade, currency convertibility etc., as indicated in the first of the Fund's Articles of Agreement:

to facilitate the expansion of balanced growth in international trade, and to contribute thereby to the promotion and maintenance of high levels of employment and real income and to the development of the productive resources of all members as primary objectives of economic policy.

The employment and output objective, perhaps, most clearly reflects Keynes' influence; the emphasis on

¹ It was probably no accident that Keynes played an important role in both conferences, but while his ideas were not adopted at Versailles – leading to his devastatingly critical (and perceptive) essay 'The Economic Consequences of the Peace' – he was determined things would be different after the Second World War and at Bretton Woods his ideas were more closely followed.

² J.M.Keynes, 'Proposals for an International Currency Union', 8/9/1941; 18/11/1941; 15/12/41; 'Plans for an International Currency (or Clearing) Union', paras. 61 to 134 of the Treasury Memorandum on External Monetary and Economic problems, 31/3/1942; White Paper on the International Monetary Fund, 7th April 1943; Joint statement by experts on the establishment of the International Monetary Fund, 22/4/1944. These are all published in D.Moggridge (ed.), *The Collected Writings of John Maynard Keynes*, XXV, 1980 (Cambridge: Cambridge University Press).

trade liberalization that of Harry White and the American contingent. But both were believed to be connected and necessary to lay the foundations for growing prosperity in the post-war world.

The IFIs were established to help carry out these functions: the IMF to oversee currency matters and to contribute to reduced currency and trade restrictions; and the World Bank to provide funds and technical advice to promote reconstruction in Europe and development elsewhere. The governance of the two institutions reflected the economic and political power of 1945 – with the US as the major economic power in the driving seat and a significant position for Europe. The Third World, then almost non-existent as an independent political entity, was ignored.

The initial design of the two institutions was not strictly appropriate to achieve either of the two fundamental objectives. Once reconstruction had been achieved, support for high employment and output required coordination of economic policies among governments representing countries with economic weight in the world and some ability to inject additional finance into the system at the international level when required. Yet, Keynes' '*bancor*' which would have achieved the latter was rejected, and the IMF was given only mild coordinating powers. As far as trade was concerned, it was the Marshall Plan and later GATT and the European Economic Community rather than the IFIs which were principally responsible for the reductions of restrictions on trade, exchange and capital movements.

3 DEVELOPMENTS IN THE WORLD ECONOMIC SYSTEM SINCE 1945

As might have been expected, the world economy has changed radically since 1945 – partly due to the Bretton Woods system itself; partly to successive trade rounds; partly to political changes; and partly to technological transformation. Important changes, relevant to the role of the IFIs, include:

- the emergence of Third World countries as independent states;

- the establishment of foreign exchange convertibility; greatly reduced restrictions on trade and capital movements, first among developed countries and more recently among developing countries;

- following reduced regulation, there was a massive expansion of both trade and international capital movements. World economic growth was 2.75 per cent p.a. from 1950-90, while international trade grew over twice as fast. Private international capital movements have expanded throughout the period, with a particular boost in the 1970s through the recycling of oil-finance; and the 1980s with deregulation;

- the role of multinational companies in world trade and investment greatly increased. By the early 1980s, trade within and between the 350 largest TNCs amounted to an estimated 40 per cent of global trade.³ Global sales of foreign affiliates in host countries are estimated to have grown by 15 per cent per annum, 1985-1990, much faster than the growth in domestic output.⁴

- following successful reconstruction in Europe and Japan, and sustained development in many Third World countries, economic power has spread much more widely, greatly diminishing the hegemonic position of the US.

- the end of the Cold War and the emergence of 'transition' as a major economic and political challenge has radically changed both political and economic maps;

- the Keynesian economic philosophy that dominated at Bretton Woods was displaced, notably from the late 1970s, by a return to belief in the market model and monetarism as the predominant philosophy in industrialized countries and the IFIs, a change which was reinforced by the collapse of communism.

4 NEW OBJECTIVES

As noted above, the major objectives that informed Bretton Woods were high levels of employment and the establishment of a prosperous world

³ C. Oman quoted in D. Ghai, 1993, 'Structural adjustment, global integration and social democracy' in D. Prendergast and F. Stewart (eds.) *Market Forces and World Development* (London: Macmillan).

⁴ United Nations, 1992, *World Investment report: Transnational Corporations as Engines of Growth* (New York: United Nations).

economy based on the promotion of free movement of goods, services and capital. In the event, in the first 20 years after the system was initiated, the developed countries achieved full employment and their major economic problem then appeared to be inflation rather than unemployment. Subsequently, when unemployment reemerged in the industrial countries and underemployment emerged as a growing problem in developing countries, the IFIs seemed to have lost sight of the employment objective, placing excessive emphasis on inflation control, sometimes at the expense of employment and output. This was partly due to the emerging dominance of the renewed monetarist philosophy.

Since 1945, other important objectives for the world economic system have gained prominence, partly as a by-product of the changes that occurred and partly in response to fresh political pressures. These include:

- **Development of Third World countries (and now promotion of successful transition).** The World Bank took this objective on as its major remit at an early stage.

- **Elimination of poverty.** At first, it was believed this would be the automatic outcome of development, but as the failure of 'trickle down' became apparent, Basic Needs was accepted as an objective by the World Bank, soon to be displaced, however, by adjustment. In the 1990s, poverty reduction has again emerged as an important world objective.

- **Problems of the unregulated market system for the environment, at many levels (ranging from soil erosion in particular villages to the world greenhouse effect), have given growing weight to environmental considerations and the objective of sustainable development.**

- **Finally, because the employment objective so clearly enunciated at Bretton Woods was neglected, it has become necessary to reintroduce high levels of employment as an objective, both in developed and developing countries.⁵**

5 IMPLICATIONS OF THE CHANGES IN THE WORLD ECONOMY AND NEW OBJECTIVES FOR THE IFIs

In principle, government supported international institutions should provide the collective action that is necessary to promote world welfare, which neither governments acting on their own, nor the market would provide. This sort of collective action is needed because there are externalities arising from certain types of action of governments (and companies, or individuals operating through the market). Because of free rider problems and deficiencies in information, only collective action will bring about the desired results.

The changes in the world economy and the new objectives just noted have strong implications for the type of collective action that is needed and also the effectiveness of the existing IFIs in promoting it.

On the one hand, it might be (and indeed has been)⁶ argued that there is no longer a role for the IFIs for the following reasons:

- they have been marginalized in capital movements, accounting for only a small fraction of the total capital that crosses frontiers (and indeed in the 1980s when most needed they actually received resources rather than paying them out). Countries, other than the very poor and those lacking in credit worthiness, now have access to private capital markets and don't need the World Bank;

- when there are major problems with international capital – eg. in both the Mexico crises (1982 and 1995) – the IFIs were in effect bypassed, brought in only to endorse prior decisions. Much the same is true of lending to some of the countries in transition, especially Russia. In the 1980s, the Brady 'solution' to the debt crisis was provided by the US Secretary for the Treasury and not by the IFIs;

- they are unable to deal with the problems of the poorest countries. After over a decade of 'adjustment' African *per capita* incomes are still falling; budgets and trade balances are still in deficit; debt has escalated; and the tragedy of ethnic strife has grown;

⁵ It is significant that the World Bank's 1995 *World Development Report* is devoted to employment, while the ILO has published its first *World Employment Report* in 1995.

⁶ e.g. by Alan Walters, 1994, 'Do we need the IMF and the World Bank?' (London: Institute of Economic Affairs).

- aid fatigue in the developed countries is likely to lessen soft transfers to poor countries, who cannot afford IBRD type lending and have very limited access to private capital markets, further reducing the role of the World Bank. Moreover, aid is not a solution to most of their problems: commodity prices and debt are of greater importance and the IFIs have shown themselves incapable of dealing with either;

- the dismantling of trade and currency restrictions which was so important a part of the original remit of the IFIs has been successful, while the WTO will take on further action on trade leaving a limited role for the IFIs;

- full employment is still, as noted, an important objective but one that has long been forgotten by the IFIs;

- coordination between the major economic powers, if it occurs at all, takes place via meetings of the G7, not through the IFIs;

With their present form and governance, the IFIs seem incapable of dealing with the new objectives and new problems of the world economy. Environmental issues are dealt with at special meetings and conventions; the strictly pro-market budget-balance philosophy debars the IFIs from dealing effectively with employment or poverty.

Yet, the new problems are global problems, needing global solutions. Ironically, they are largely problems of excessive rather than deficient markets – hence part of the difficulties for the IFIs in dealing with these problems, given their strong belief in the market. For example, it has become clear that the unregulated capital market can lead to dangerous fluctuations in capital movements, playing havoc with economic management and development, as in Mexico.⁷ Some international regulation, and perhaps taxation, is needed. Similarly, some world regulation is needed to prevent exploitation and tax avoidance by TNCs. Competition in promoting supplies between poor countries, (currently encouraged by the IFIs), leads to falling commodity prices

(also of labour-intensive manufactures) sometimes so sharply that the result is immiserizing growth.⁸ Unregulated trade competition can also lead countries to compete by eliminating labour standards, encouraging child labour, avoiding environmental regulations, etc.

Global institutions are needed not only to promote the new objectives but also to react to the excesses resulting from the market reforms.

The functions Global Financial Institutions (GFIs)⁹ should have as the century ends derive from current global objectives noted above and the problems that have emerged from an unregulated global market. Each function arises from the special needs for collective action at a global level, and relates to issues that cannot be dealt with satisfactorily at a national level.

The discussion above suggests the following as the main functions of global financial institutions designed to meet the need for global collective action:

- Coordination of macroeconomic policy among the main economic powers, so as to secure a steady expansion of world output and promotion of employment.
- Renewed use of the SDR as a source of additional liquidity, to be used (a) to supplement world reserves and world demand when deemed necessary to avoid deflation; and (b) to support the finance of adjustments in poor developing countries and countries in transition.
- Supervision and regulation of capital markets, including administration of a 'Tobin' tax on capital transactions;
- Supervision and regulation of multinational companies, including developing and administering anti-trust legislation at a global level; development and administration of codes of conduct; development and administration of taxation of multinational companies;

⁷ It is worth noting that this danger was foreseen by Keynes and the initial remit for the IMF did not include relaxation of capital controls.

⁸ For example, Ghana's large increase in cocoa exports (in volume) was more than offset by declining world prices in the 1980s, so foreign exchange earnings from cocoa fell.

⁹ I use the term Global Financial Institution (GFIs) to indicate that these would be radically different from existing IFIs, though they might evolve from them.

- Development of global environmental standards; mechanisms of enforcement; monitoring.
- Development and monitoring of a World Social Charter, covering basic social rights, including access to basic goods and services and the elimination of poverty; financial flows would be used to support the achievement of the rights embodied in the World Social Charter and social conditionality would be used as a lever to secure appropriate domestic action.
- Development of appropriate environmental and labour standards, with the standards varying with the level of income of the country.
- Monitoring trends in commodity prices and devising policies, including producer taxes coordinated across countries, to help reduce excess supplies and downward movement in prices.¹⁰

The list of functions to be performed by the GFIs is a preliminary one, which would be added to (and subtracted from) as the institutions develop and new needs emerge.

GFIs with these functions would be playing the role that public institutions ought to play – *viz.* compensating for externalities and market imperfections that occur at a world level and helping meet world economic objectives. But it is unrealistic to expect that the present IFIs could be readily transformed into the proposed GFIs, without first reforming their governance.

6 REFORM IN GOVERNANCE OF THE INTERNATIONAL ECONOMIC INSTITUTIONS

The first requirement for any reform is a radical change in governance. The reformed mandate proposed above is unlikely to work without a parallel change in governance. There are two major problems with IFIs' present governance – the level of decision maker involved and the composition and voting structure of their Boards of Governors. The level is too low, and hence when governments wish to take serious decisions they convene Ministerial meetings. The voting structure of the Boards is too heavily weighted to the industrial powers and fails

to give sufficient weight to others (developing countries; countries in transition) who are all seriously affected by their actions, and would be more so with the proposed reforms in mandates to be considered below. While the IFIs are formally part of the UN system, they operate independently of the UN and are not regarded as genuinely world institutions, but rather they tend to be viewed as the instruments of the major industrial countries.

Reformed Governance: I would propose to allocate power over the IFIs to a newly formed Economic and Social Security Council (ESSC) at the UN, parallel to the Security Council, but with responsibility for economic and social matters. Like the present Security Council, the ESSC would be composed of some permanent members and also representative countries from the rest of the world. The permanent members would include the major economic powers in the world (US, Japan, Europe, China); revolving membership would include representatives of all other parts of the world. Majorities of three-quarters would be needed for decision making, the composition of the Council being such that no single category of country could secure a three-quarters majority. Hence the ESSC would (like the Security Council) be much more comprehensive than the G7, but its representation would allow for greater weight to be given to more powerful countries, to reflect the realities of power and decision making in the world.

The ESSC would make the most important decisions concerning world collective action on economic and social matters, including defining the objectives of the Global Financial Institutions (GFIs), and providing them with overall guidance, and deciding when institutional reform was needed. The ESSC could call for changes by national governments (although these would not be binding). The GFIs would continue to have their own Boards, but these would be responsible to the ESSC as the major world economic decision making body. The ESSC would meet regularly to oversee world economic development, review progress and identify changes in national and international policies; emergency meetings would be convened during a world economic crisis. The ESSC would attempt to devise solutions to critical problems or request the GFIs to do so.

¹⁰ This was intended to be the function of the abortive International Trade Organization which emerged from Bretton Woods. It should be emphasized that the ITO functions then proposed are quite different from those allocated to the WTO at present.

This structure of governance would enhance participation in world economic decision making; and place the GFIs firmly within the United Nations, under the direction of a political body, the ESSC.

The matrix below indicates the role of the ESSC and how the proposed functions might be allocated as between the existing IFIs. The functions extend beyond 'finance' strictly speaking (as do the actions of the existing IFIs). For some functions (e.g. environment) there might be a case for developing a new institution rather than allocating the function to an existing institution. But for present purposes

it is assumed that the functions would be performed by one or other of the three existing institutions (IMF, WB, WTO).

7 A NEW ECONOMIC PHILOSOPHY

The new allocation of functions proposed above would not be workable if the IFIs retained their present rather rigid market-oriented and anti-Keynesian philosophy. Modern economics provides a rich menu of reasons why this simple market philosophy is incorrect, justification for public action and alternative ways of thinking about economic development more generally. These

Functions of the proposed global financial institutions					
Function	ESSC	Reformed IMF	Reformed WB	Reformed WTO	Present system
Supervise capital movements	Overall policy	+ Supervise tax	0	0	BIS/IMF poorly and <i>ad hoc</i>
Global environmental regulations	Overall policy making	0	+ Regulations devised	+ Regulations monitored	<i>ad hoc</i>
Social objectives	Overall policy making – devise social charter	+ Adapt policies	+ Social conditionality	0	UNICEF/UNDP/ ECOSOC with insufficient effects
Domestic environment and labour standards	Overall policies – guidelines	0	0	+ Use of trade weapon	No-one for environment ILO for labour
Commodity policies	Overall policies	+ Support policies with finance and administration	+ Support policies with diversific projects	0	UNCTAD once; no-one now
Macro-policy coordination	+ Main venue	+ Analytic support	0	0	<i>Ad hoc</i> , G7
SDRs and demand	Overall policies	+	0	0	IMF – but too limited

alternatives are supported by a large amount of empirical work showing how real markets, institutions and economies operate. The new institutions will not succeed unless they are open to alternative approaches and ways of thinking. Strong political direction will be necessary to bring about such a change in thought, as well as appointments of open-minded people at the highest levels in these institutions. A change in recruitment procedures and, perhaps, in location might also be helpful. The institutions need to be much more open to dialogue with others with different views; and, in country work, to views of governments and citizens.

8 CONCLUSIONS

The IFIs are becoming marginalized in world economic decision making and capital flows. The half-century and also the millennium provide a good opportunity to rethink their mandates. Three options are possible: to close them down as being no longer relevant to the present world; to let them continue to react to events, which may be useful to the achievement of policy objectives of industrialized

countries, but makes little contribution to global problems, and may indeed make some problems worse, by reducing public action and giving an excessive role to the market; or to undertake radical reform to enable the institutions to respond to present global economic and social issues. The last seems clearly preferable, but also most difficult to achieve, since no powerful countries are sufficiently alarmed by present problems to want major reforms. The unregulated movement of international capital and goods or global environmental damage will have seriously to threaten interests in the powerful countries before major institutional change becomes likely. In the meantime piecemeal reform, in response to particular crises, is most likely with a continued gradual erosion of the importance of the IFIs. Neither a 50 year birthday, nor the ushering in of a new century are likely to be enough, in themselves, to induce radical reform. But the global problems which provide the justification for reform are real and growing; without reform the dysfunctionality of the current system is likely to become increasingly apparent.

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